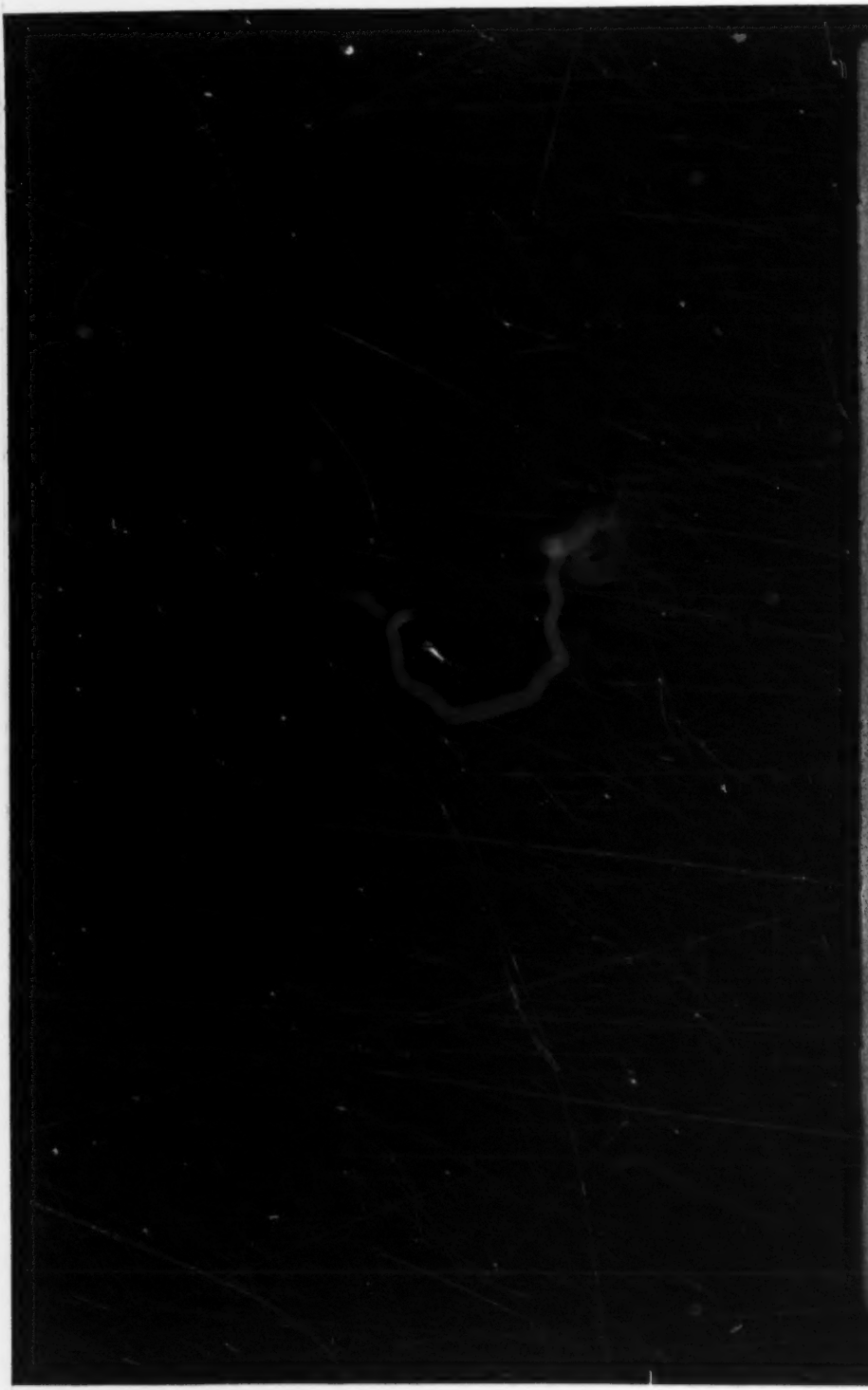

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# In the Supreme Court of the United States

OCTOBER TERM, 1946

No. 129

COLUMBIA GAS & ELECTRIC CORPORATION,
PETITIONER

*v.*

UNITED STATES OF AMERICA, BEN WILLIAMSON, JR., TRUSTEE OF INLAND GAS CORPORATION, RUSSELL VAN HORN, ET AL., AS A COMMITTEE FOR BONDHOLDERS, AND MORRIS GREEN

No. 130

COLUMBIA GAS & ELECTRIC CORPORATION,
PETITIONER

*v.*

UNITED STATES OF AMERICA, BEN WILLIAMSON, JR., TRUSTEE OF KENTUCKY FUEL GAS CORPORATION, AND MORRIS GREEN

No. 131

COLUMBIA GAS & ELECTRIC CORPORATION,
PETITIONER

*v.*

UNITED STATES OF AMERICA, CLINTON M. HARBISON, TRUSTEE FOR AMERICAN FUEL AND POWER COMPANY, ET AL., AND LOUIS A. GREEN, AND ROBERT HEILBRUNN, AS A COMMITTEE FOR NOTE HOLDERS

*ON PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT*

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**BRIEF FOR THE UNITED STATES AND THE SECURITIES AND EXCHANGE COMMISSION IN OPPOSITION**

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**OPINIONS BELOW**

The district court rendered no opinion but filed findings of fact and conclusions of law (R. I, 590–603[1]). The opinion of the Circuit Court of Appeals is reported in 151 F. 2d 461 (R. IX, 3–23, 46) and its opinion denying petition for rehearing is reported in 153 F. 2d 101 (R. IX, 56–57).

The opinion of this Court dismissing an appeal from the judgment of the district court is reported in 322 U. S. 379. The opinion of the Circuit Court of Appeals on an appeal taken at an earlier stage of the proceedings is reported in 122 F. 2d 223.

**JURISDICTION**

The decrees of the Circuit Court of Appeals were entered on October 9, 1945, and were amended on November 26, 1945, and petition for rehearing was denied on January 21, 1946 (R. IX, 1–2, 46–56). An order entered by the late Chief Justice extended petitioner's time for applying for writs of certiorari to June 1, 1946 (R. IX, 59),

[1] Since the pagination of the nine volumes of the record is not consecutive, the volume and page of the record will be designated, respectively, by Roman numerals and arabic numerals.

and the petition for writs of certiorari was filed on May 29, 1946. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the court below erred in holding that a proper exercise of the equitable powers vested in bankruptcy courts in corporate reorganization proceedings requires that the claims against the debtor corporations which the petitioner had acquired, together with stock control, for the purpose and with the effect of precipitating foreclosure proceedings against the debtor corporations and preventing their successful operation, be subordinated to the claims of all other creditors of the debtor corporations.

STATEMENT

The proceedings leading up to the decision sought to be reviewed are summarized in *Columbia Gas & Electric Corp.* v. *American Fuel and Power Company,* 322 U. S. 379, and may here be briefly restated.

Separate proceedings were brought under the Bankruptcy Act for the reorganization of American Fuel and Power Company and two of its subsidiaries, Inland Gas Corporation and Kentucky Fuel Gas Corporation (referred to herein, respectively, as American Fuel, Inland and Kentucky Fuel). The Securities and Exchange Commission became a party to the proceedings

pursuant to Section 208 of the Bankruptcy Act (11 U. S. C. 608). Petitioner, as the holder of various claims against the debtors, filed its proofs of claims in the reorganization proceedings; and the district court, on application of the debtors' trustees, entered an order approving a proposed compromise settlement of petitioner's claims. On appeal by certain creditors, the Circuit Court of Appeals reversed this order upon the ground that the facts disclosed that petitioner had acquired and used its claims in violation of the federal antitrust laws and that such claims are not provable or allowable claims in a bankruptcy reorganization. In rejecting the proposed compromise the court also relied upon the equitable principles applied in *Taylor* v. *Standard Gas & Elec. Co.*, 306 U. S. 307, and *Pepper* v. *Litton*, 308 U. S. 295.[2] The cause was accordingly remanded to the district court with instructions to reject all claims which the petitioner had acquired in violation of the federal antitrust laws.[3] 122 F. 2d 223.

Following remand to the district court, the United States, which had instituted an equity proceeding against petitioner in another federal

[2] This was the position urged by the Securities and Exchange Commission.

[3] The opinion pointed out that petitioner had not appeared in the proceeding for approval of the proposed compromise of its claims and that it was therefore not bound by the facts stated in the court's opinion.

district court based upon allegations that it had acquired control of the American Fuel companies in violation of the antitrust laws, was allowed to intervene. After a trial in which petitioner participated, the district court, after filing findings of fact and conclusions of law, entered judgment rejecting all the petitioner's claims (R. I, 604).

The findings of the district court, having been approved by the appellate court, represent the concurrent findings of two federal courts. The findings disclose the following:

Inland, Kentucky Fuel, and American Fuel were organized in 1927 and 1928 by the same group of persons to acquire natural gas reserves in eastern Kentucky and to transport and sell gas from this field to industrial consumers (Fngs. 1–3; R. I, 590–593). Bonds or secured notes of the companies were sold to the public, the promoters and underwriters retaining all of their common stock (*ibid.*).[4] From the beginning the companies were under the management of Hope Engineering Company (referred to herein as Hope), which had wide experience in building natural gas transmission lines and in successfully promoting natural gas enterprises (Fng. 10; R. I, 595).

[4] When American Fuel was organized, the common stock of Kentucky and Inland Fuel was exchanged for that of American Fuel, which then became the parent of Inland and Kentucky Fuel (Fng. 3; R. I, 591–592).

Prior to the organization of the American Fuel System, petitioner's subsidiaries, which produced, transported, and sold natural gas to industrial and domestic consumers in Kentucky, Ohio, and West Virginia, enjoyed virtual freedom from competition in the fields which they occupied in these states (Fngs. 5, 7; R. I, 593–594). The operations of the American Fuel companies changed the situation and took away some of the largest industrial customers of petitioner's subsidiaries (Fng. 7; R. I, 594). By the end of 1929 this competition had become "serious and threatening" (*ibid.*).[5]

Inland and Kentucky Fuel sustained substantial operating losses in 1928 and 1929 (Fng. 9; R. I, 594) and it was recognized that a large expansion of business was necessary to make the enterprise profitable. Hope proposed, as a solution to the problem, that the companies undertake to supply gas to industrial users in the Detroit area, which was not then served with natural gas. Hope succeeded in enlisting the participation of a group (referred to herein as the Syndicate) having sufficient "financial strength and business experience to foreshadow success" of the under-

[5] As the court below noted (R. IX, 17–18), petitioner "was fully conscious of the threat to its subsidiaries" and it "manifested early and continued hostility to the venture, and exerted every possible influence to thwart its successful fruition."

taking.[6] This Syndicate made an immediate investment of $654,000 and acquired more than half of the stock of American Fuel. The Syndicate, through controlled corporations, applied for a franchise to lay gas pipe lines under the streets of Detroit, surveyed and acquired the right of way for a transmission line from eastern Kentucky gas fields, started the work of laying pipes under the Ohio River, and secured contracts for sale of gas to industrial consumers both in the Detroit area and in the territory adjacent to the proposed line. A nationally known and highly reputable natural gas engineer, who was employed to investigate and analyze the project, reported that "the gas reserves are sufficient, the industrial market is adequate and * * * this project as a whole is a sound business proposition." (Fng. 10; R. I, 595–597.)

During this same time petitioner was making plans to supply natural gas to Detroit from its Kentucky and West Virginia fields (Fng. 11; R. I, 597). These plans were "seriously threatened" by the proposed expansion of the American Fuel System (Fng. 12; R. I, 597). During the first four months of 1930 petitioner undertook

[6] The Syndicate consisted of "a prosperous and successful investment trust" allied with a strong banking organization which had financed many gas enterprises and an organization which had successfully built and operated natural gas projects (Fng. 10; R. I, 595).

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to put itself in a position to force foreclosure and sale of the properties of Inland and Kentucky Fuel, by buying on the open market, while concealing the fact that it was purchaser, more than 25% of the bonds of each of these companies (Fng. 9; R. I, 595).[7]

The negotiations resulting in petitioner's acquisition of the Syndicate's interest in the American Fuel System were initiated by O. R. Seagraves, a Syndicate member whose confidence in the Detroit project had been considerably shaken (Fng. 14; R. I, 599–600).[8] The other Syndicate members, however, did not fully share his views and the large profit which they realized from the sale to petitioner was the principal inducement leading them to agree to the deal (*ibid.*). Under the contract made October 30, 1930, petitioner paid the Syndicate $2,826,789.28, which reimbursed the Syndicate's entire investment in the American Fuel System and gave the Syndicate a clear profit of $350,000 (Fng. 13; R. I, 598). In addition, petitioner agreed to employ Hope on work on terms which would give it not less than $800,000

[7] The companies' bond indentures provided that if there was a default in interest or sinking fund requirements the indenture trustees should, upon the request of the holders of 25% in principal amount of the bonds, declare defaults and institute foreclosure proceedings (Fng. 9; R. I, 594–595).

[8] A collateral inducement in his case was the prospect of his making a profitable contract with petitioner with reference to gas fields in the Southwest in which he was interested (*ibid.*).

as compensation, an obligation which petitioner later discharged by paying Hope $400,000 without its having done any work (Fng. 13; R. I, 598–599).

The Syndicate had not abandoned the Detroit project at the time that it sold its holdings to petitioner but whether the project would have ultimately succeeded lies in the realm of speculation (Fng. 15; R. I, 600).

Prior to petitioner's acquisition of control of the American Fuel companies, its responsible executive officers had stated that it would not lie idly by and permit the construction of a pipe line through the heart of its territory as proposed by the Syndicate (Fng. 16; R. I, 600).[9] In buying out the Syndicate, petitioner had agreed to save Hope harmless on its obligation to advance funds to meet sinking fund obligations of the debtors (Fng. 13; R. I, 599). By the use of claims acquired by petitioner from the Syndicate, it promptly precipitated receivership proceedings against Inland and Kentucky Fuel and petitioner's nominee became receiver of the companies (Fng. 13; R. I, 599). Petitioner's acquisition of control resulted in immediate discontinuance of all efforts to promote their Detroit project and of

[9] As the court below pointed out, petitioner's president had declared that "if anyone thinks Columbia will allow a ditch to be dug across the State of Ohio, he is just crazy" and that if Columbia came into the picture it would have to "put the company [American Fuel] through the wringer" (R. IX, 18).

any additional competition between subsidiaries of petitioner and American Fuel (*ibid.*). Petitioner's main purpose in acquiring control of the American Fuel System was to restrain actual and potential competition and any plan to utilize the properties of the System as a legitimate adjunct of its own business was merely collateral and incidental to this main purpose (Fng. 17; R. I, 601).

On appeal, the court below held that the case was governed by the principles laid down in *Pepper* v. *Litton,* 308 U. S. 295, and *Taylor* v. *Standard Gas & Elec. Co.,* 306 U. S. 307—that a bankruptcy court sits as a court of equity in passing upon claims and will not, under ordinary equitable principles, recognize a claim "which is being asserted as part of a scheme by a dominating stockholder to defeat the lawful prior claims of creditors" (R. IX, 14). The court further held that these principles were applicable because the debtors and their creditors had been injured by petitioner's "inequitable or illegal conduct" (R. IX, 15). This injury resulted from the fact that petitioner's activities had "forever destroyed" the opportunity for recovery and profit afforded by the expanded market which completion of the Detroit pipe line would open up (R. IX, 19). Opportunity to pursue this project, in which lay the debtors' hope of financial rehabilitation, was clearly a valuable asset of theirs which petitioner, in the pursuit of its own conflicting interest, had

destroyed. As the court below said, "It is idle, therefore, to contend that the elimination of that prospect was not an injury to them [the debtors and their creditors], however impossible it may be to measure their damage" (R. IX, 20).

The court amended the district court's judgment so as to subordinate petitioner's claims to the claims of all other creditors of every other class, and affirmed the judgment as so amended (R. IX, 46).

## ARGUMENT

### I

The petitioner contends (1) that the basis upon which the court below subordinated petitioner's claims was that the claims had been acquired in violation of the federal antitrust laws and (2) that the court, in thus subordinating its claims as a means of vindicating these laws, erroneously inflicted a penalty for violation which the laws themselves neither authorize nor prescribe (Pet. 22).

The Government submits that the decision below does not rest upon the ground stated by petitioner and that the legal question raised by the second part of its contention is therefore not presented. The court below, as previously stated (*supra*, p. 10), merely applied the general principle that when a controlling stockholder of a corporation manages its affairs so as to promote, not the in-

terests of the corporation but those of the controlling stockholder, a bankruptcy court will subordinate the claims of the wrongdoer to the claims of creditors and minority stockholders injured by this breach of trust. With respect to the antitrust laws the court held merely that "the power and duty of equity" to require subordination of petitioner's claims could not be limited by the fact that petitioner's inequitable conduct was such that it violated those laws. The court said (R. IX, 21):

> The argument that the court, for alleged violations of the Anti-Trust Laws, imposed in a bankruptcy proceedings penalties other than those specified in the Anti-Trust Statutes, must be rejected. The court imposed no penalties; it but exercised its equity power to deny relief to a creditor seeking enforcement of contracts entered into illegally or tainted with inequity. To apply the doctrine so vigorously urged by Columbia, is to deny the power and duty of equity, to reject demands arising out of illegal or inequitable conduct whenever such conduct is subject to legal penalties imposed by state or federal law, and so to limit it to that narrowly restricted field in which the chancellor may sense inequity even in the absence of statutory condemnation. A denial of this contention does not mean, of course, that the power may be invoked in respect to conduct consti-

tuting no wrong to the parties or interests in litigation.

The essence of the court's decision is that the petitioner's claims were subordinated because of petitioner's inherently inequitable conduct. Certainly, the general duty of a bankruptcy court to subordinate the interests of a claimant guilty of inequitable conduct does not disappear when such inequitable conduct may, in addition, constitute a violation of the antitrust laws or any other laws. The crucial consideration here is that the decision turned on petitioner's inequitable conduct, without regard to whether or not there had been a violation of the antitrust laws. Accordingly, the decision below does not raise the question which petitioner seeks to present (Pet. 2–3), namely, whether a creditor who had violated the antitrust laws in acquiring the credit must be subordinated to other creditors.

## II

Petitioner also contends (Pet. 29) that, in the absence of injury caused by petitioner to the security holders of the debtor corporations, the judgment of subordination was beyond the general equity powers of the court. The question sought to be raised is not presented since the court below explicitly declared that injury caused by petitioner's wrongdoing was essential to the validity of the judgment entered in this case. The

court said: "To sustain the judgment below the appellees must have proved not only inequitable or illegal conduct, but that the debtors, the stockholders or public creditors were injured thereby" (R. IX, 15). Furthermore, the major portion of the opinion (apart from the court's recital of the facts and applicable legal principles) is devoted to rebuttal of the various grounds upon which petitioner asserted that its actions were not shown to be injurious to the debtor corporations and their security holders (R. IX, 15–21).

Petitioner contends (Pet. 19, 32) that the debtors were doomed to failure and that this would have occurred if the petitioner had never entered the picture. This assertion is belied by the findings and by petitioner's own action. Until petitioner gained control of the debtors the Detroit project, which held out substantial prospect of success, had not been abandoned by the Syndicate, which was "ready, able and willing" to continue its efforts to develop the project (Fng. 15; R. I, 600). The contention that the debtors were headed for receivership and could never have rehabilitated themselves if petitioner had not intervened is totally inconsistent, as the court below pointed out, with the fact that petitioner "paid approximately $3,000,000 for stock control [of the debtors] and assumed heavy obligations subsequently liquidated by substantial payments" (R. IX, 18). What petitioner was

interested in was the failure of the American Fuel enterprise; and petitioner, in effect, appraised the chances of success of the enterprise as warranting an expenditure of well over $3,000,000 to assure failure.

Petitioner attempts (Pet. 31–32) to distinguish the nature of the injury to the debtors in this case from the injury to the debtor corporation in the *Deep Rock* case (*Taylor* v. *Standard Gas & Electric Co.*, 306 U. S. 307). It is entirely fortuitous that the parent company whose claim was subordinated in the *Deep Rock* case was the promoter of the debtor and that the mismanagement there revealed had covered the entire life span of the debtor, whereas the present petitioner acquired control of the debtors when they were suffering under handicaps attributable to persons not connected with petitioner.[10] The equitable basis for resolving any doubt as to the consequence of petitioner's wrongdoing is far stronger here than in the *Deep Rock* case in view of the fact that petitioner deliberately intended to stifle the debtors. Any claim to distinction based upon differences of degree as to the certainty of harmful consequences

[10] Subordination in the *Deep Rock* case, as this Court subsequently pointed out, "was based on the equities of the case—the history of spoliation, mismanagement, and faithless stewardship of the affairs of the subsidiary by Standard to the detriment of the public investors". *Pepper* v. *Litton*, *supra*, p. 308.

from the misconduct of the dominant corporation raises merely a question of causation, which is basically one of fact. Petitioner concedes (Pet. 8) that it is not warranted in asking this Court to reexamine the voluminous record in view of the concurrent findings of both lower courts.

III

While petitioner has made little attempt to deal with the actual grounds of decision of the court below or to show error therein, the court's decision as we shall show, falls squarely within principles which this Court has repeatedly applied.

Petitioner secured control of the debtors with the intent of acting solely in its own interest by destroying a serious threat to its monopolistic position, and petitioner immediately accomplished its purpose by causing the debtors to collapse. Petitioner neither expected nor desired the debtor companies to prosper since their prosperity meant further inroads on petitioner's industrial gas business.[11] Petitioner's acquisition of the debtor's securities was incident to its scheme to profit at the expense of its fellow security holders, to whom petitioner, as a controlling security holder, owed fiduciary duties. This principle of fiduciary re-

[11] As pointed out by one of petitioner's witnesses, the American Fuel System took "the cream of the business" and left petitioner "the skimmed milk" (R. IV, 1862).

sponsibility is well settled.[12] In *Farmer's Loan and Trust Co.* v. *New York & N. Ry. Co.*, 150 N. Y. 410, 431, the court said that "a corporation, purchasing a majority of the stock of another competing one, cannot obtain control of its affairs, divert the income of its business, refuse business which would enable the defaulting company to pay its interest, and then institute an action in equity to enforce its obligations, for the avowed purpose of obtaining entire control of its property to the injury of the minority stockholders."

This Court has repeatedly held that a bankruptcy court, as a court of equity, should require the subordination or disallowance of the claims and interests of a guilty parent company to those of public investors in its subsidiaries. *Taylor* v. *Standard Gas & Electric Co., supra; Pepper* v. *Litton, supra; American United Mut. L. Ins. Co.* v. *City of Avon Park,* 311 U. S. 138, 149; *Sampsell* v. *Imperial Paper & Color Corp.,* 313 U. S. 215, 219. Subordination and disallowance are equitable remedies to undo the wrong where control has been exercised "for the aggrandizement, preference, or advantage of the fiduciary to the exclusion or detriment of the *cestuis.*" *Pepper* v. *Litton, supra,* at p. 311. Petitioner's conduct falls di-

[12] *Jackson* v. *Ludeling*, 21 Wall. 616, 622; *Southern Pacific Co.* v. *Bogert*, 250 U. S. 483, 492; *Taylor* v. *Standard Gas & Electric Co.*, 306 U. S. 307; *Pepper* v. *Litton*, 308 U. S. 295.

rectly within this description despite the fact, emphasized by petitioner, that it purchased the debtors' securities for value. Application of subordination does not depend upon technical concepts and is not limited to any narrow fact situation. A "sufficient consideration may be simply the violation of rules of fair play and good conscience by the claimant; a breach of the fiduciary standards of conduct which he owes the corporation, its stockholders and creditors." *Id.* at pp. 310–311.

Thus the subordination enforced by the judgment below is no more than an application of the general principles that a guilty fiduciary must bear all the risks of loss inherent in his conduct (Scott, *Trusts* (1939), Sec. 205) and of the maxim that one must come into equity with clean hands. Such treatment is appropriate to prevent petitioner from participating on a parity with other investors in the assets of the insolvent estates since the predicament in which the estates find themselves stems from petitioner's precipitation of receiverships and the accompanying abandonment of the Detroit project. The fact that petitioner acquired its claims pursuant to a conspiracy in violation of the federal antitrust laws further emphasizes the illegality and inequity of the acts of petitioner causing injury to the debtor corporations and their security holders.

Where a transaction between a corporation and its controlling stockholder is challenged, the burden is on the latter "not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein." *Pepper* v. *Litton, supra,* at p. 306. It is exactly because it may be impossible to determine to what extent the actions of petitioner, which were taken on its own behalf in disregard of the rights of its cestuis, prevented future success that subordination is appropriate. It provides a remedy for innocent security holders against wrongful conduct even though the extent of their injury may not be susceptible to legal proof. In the *Deep Rock* case, *supra,* where the Court required subordination, the Court said (at p. 323):

> It is impossible to recast Deep Rock's history and experience so as even to approximate what would be its financial condition at this day had it been adequately capitalized and independently managed and had its fiscal affairs been conducted with an eye single to its own interests.

## CONCLUSION

The decision below is correct and there is no conflict of decisions. The principal question which petitioner seeks to present is not raised by the decision below. It is therefore respectfully

submitted that the petition for a writ of certiorari should be denied.

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